BRIEF IN SUPPORT OF PETITION

Statement

The petition contains a statement of the facts and circumstances here pertinent.

Specifications of Error

The Circuit Court of Appeals for the Second Circuit erred in the instant case:

1. In failing to give effect to the local law that the payments made by a third person to stockholders of a corporation belonged to such stockholders absolutely and in their own right.

2. In holding that the Government may, as a matter of course, collect the income taxes out of any income upon which the taxes were computed.

3. In holding that the corporate income taxes of the lessor could be collected out of the personal property of its shareholders.

4. In holding that present shareholders are personally responsible for income taxes which accrued by reason of payments made to former stockholders.

POINT I

Under clear local law the payments from the lessee to the stockholders of the lessor are their sole and absolute property and cannot be appropriated by the Government or any other creditor of the lessor.

The purposes of all parties in 1868, when the lease was made, are clear from what they did.

As to Stockholders. Of necessity, the lease had to be satisfactory to the stockholders since it could not have been made against their consent. It worked an entire transformation in the nature and character of their securities. To each stockholder it was of prime importance that the stipulated fixed payments be placed completely beyond the power of the lessor, their fellow stockholders and the directors of the lessor to invade or imperil. This accounts for the provision that the payments be made directly to each stockholder in his own right. Unquestionably under local law this made the payments free of any future debts or liabilities of the lessor corporation. Furthermore, the lessee assumed the responsibility of paying all outstanding and prospective obligations of the lessor. This was accomplished, first, by the terms of the lease, and, second, by the contract of payment endorsed upon the certificates themselves.

As to the Lessee. The lessee financed its acquisition of the property of the lessor by obligating itself to make stipulated payments of "interest." It will be noted that while the lease refers to payments to be made to stockholders as "interest," the endorsement on the certificates refers to them as "dividends." They, clearly, are not dividends

since they represent no share in the profits and are paid by the corporation to persons who are not its stockholders.

As to the Lessor. It was to be, and was, retired entirely from business. The difficulty that has arisen here is occasioned by the levy of taxes upon a corporation which engages in no business and which is entirely dormant, if not dead, and which has no funds or property except the reversion under the lease.

(a) *The Government as a creditor has no greater rights than the lessor.*

For each and every purpose the Government stands in the shoes of the lessor. The Government here is a creditor, although of course it has priority as against other creditors. *Price* v. *United States* (1926), 269 U. S. 492. "Income taxes, apart from the right of preference in payment, are but debts" (*United States* v. *Western Union Telegraph Co.* (1931) (2d) Circuit, 50 Fed. 2d 102).

In *United States* v. *Warren R. Co.*, 127 Fed. (2d) 134, 137, where the facts were similar to those here presented, the Court below said, "It (the Government) can, however, have no right under any theory beyond that of the lessors themselves."

(b) *The Lessor is Powerless to Touch the Payments due to the Stockholders—and so is the Government.*

The Court below has exercised the powers of a Marshal in seizing property in satisfaction of a claim which the Government has against the lessor. The seized property does not belong to the taxpayer. It belongs to the stockholders absolutely and in their own right. This presents a question of title where the local law is not only to be followed (*Erie Railroad* v. *Tompkins,* 304 U. S. 64), but

is wholly controlling (*Freuler* v. *Helvering*, 291 U. S. 35; *Lyeth* v. *Hoey*, 305 U. S. 188; *Poe* v. *Seaborn*, 282 U. S. 101).

The stockholders do not take the payments through the lessor. Their rights vested 75 years ago. By no conceivable action may the lessor, the lessee and all the other 6,000 stockholders of the lessor rightfully deprive a single stockholder of his right to the payments contracted to be paid to him directly. This is indisputably true under the laws of the State of New York and New Jersey, whichever is controlling. (We believe it better to meet the problem this way than to attempt to determine whether the law of New Jersey or New York controls. The lessee is a Pennsylvania corporation. The lessor is a New Jersey corporation. The property concerned is located in New Jersey. The lease was acknowledged before a Master in Chancery in New Jersey, but, apparently, in New York City.)

Local cases where the facts were less clear and strong in favor of the stockholders are:

Nina H. Peabody v. *Interborough Rapid Transit Company*, 124 Misc. 801, affirmed 213 App. Div. 857, affirmed (1925) 240 N. Y. 708; *Bowers* v. *Interborough Rapid Transit Company* (1923), 121 Misc. 250, affirmed 208 App. Div. 768. In those cases the lease was less favorable to the stockholders for it required the lessor to declare a periodic dividend equal to each installment of rent. Some years after making the lease, the lessee enjoyed less earnings than had been anticipated and had become financially embarrassed. In order to avoid receivership, it was proposed that the stockholders of the lessor accept 5% in lieu of the 7% contracted for. The lessee, the lessor and 90% of the stockholders of the lessor consented and the lease was subsequently amended. The dissenting stockholders were successful in collecting the full amount of the dividends payable to them under the

original lease under the law of the State of New York that they as third party beneficiaries had obtained vested rights of which they could not be deprived without their consent. Other cases decided by the highest Court of the State of New York are: *Gifford* v. *Corrigan,* 117 N. Y. 257; *Seaver* v. *Ransom,* 224 N. Y. 233, where it was held that the third party beneficiary obtained a vested and indestructible right which could not be defeated without his consent.

The law of New Jersey is the same as New York. *Bijur* v. *Standard Distilling Co.,* 74 N. J. Eq. 546, 70 A. 934, aff'd 78 N. J. Eq. 582; *Fleming* v. *Reed,* 77 N. J. L. 563. In one further respect the law of New Jersey is even more favorable to the stockholders than that of New York. In New Jersey a lease in perpetuity is, in legal effect, a conveyance for the purposes of the questions here presented. *Wilson, et al.* v. *Moorland Farms Corp., et al.,* 102 N. J. Eq. 425, 427; *Black* v. *Delaware and Raritan Canal Co.,* 24 N. J. Eq. 455. The very lease here involved was adjudged by the Court below in *Anderson* v. *Morris & Essex R. Co.,* 216 Fed. 83, as follows: "The lease for all practical purposes was a conveyance in fee."

In legal contemplation, therefore, for all questions here presented, seventy-five years ago the lessor conveyed its property to the lessee upon the lessee's agreement to pay the purchase price directly to the stockholders of the lessor. Now the Government attempts to take from these stockholders property which vested in them at the time of the conveyance on account of claims that arose against the taxpayer years subsequent to the date of the conveyance.

The Court below refused to follow its prior decisions in *United States* v. *Western Union Telegraph Co.,* 50 Fed. (2d) 102; *Harwood* v. *Eaton,* 68 Fed. (2d) 12; *Western*

Union Telegraph Co. v. *Commissioner,* 68 Fed. (2d) 16, wherein it did follow and apply the local law.

Other Circuit Court of Appeals have held that where a beneficiary of a revocable policy of insurance, under local law, has some right in the policy, its cash surrender value may not be taken by the Collector to satisfy an income tax claim against the insured. (*Cannon* v. *Nicholas* (10th Circuit), 80 Fed. 2d 934; *Kyle* v. *McGuirk* (3rd Circuit), 82 Fed. 2d 212.)

POINT II

Because an income tax may be assessed upon certain income, it does not necessarily follow that the Government may collect the tax from that income.

The distinction we wish to emphasize is the difference between the assessment of an income tax and collecting it. An income tax may be assessed upon income received, income fictitiously or constructively received, but it may be collected only out of and from the property of the taxpayer or debtor.

There are many circumstances in which a person may be taxed upon income constructively—fictitiously—received. Under prior statutes a man who, upon a divorce, established a trust fund for his wife in lieu of alimony was taxed upon the income of the trust (*Douglas* v. *Willcuts,* 296 U. S. 1). Of course, the Congress might assess, as it now has, an income tax against the wife computed upon her receipt of the income; but Congress cannot assess the husband with a tax computed upon such income and collect the husband's tax out of the wife's property. In the case

at bar, the individual stockholders pay their own income tax upon the payments they receive. The objection is to the attempt to compel them to pay another's income tax, too.

Another illustration is where a trust is revocable by a person not having an interest substantially adverse to the grantor, the income is taxable to the grantor (26 U. S. C. A. 166, Reg. 103, § 19.167-1). The Government could, of course, tax the beneficiary but it cannot collect the grantor's income tax from the beneficiary of the trust.

Again, take the case of a man who spent not only the salary which he has earned in one year but has assigned subsequently accruing salary for a consideration and has spent that, too. The Government cannot collect the assignor's income tax from the assignee.

Yet, the Court below held that since the Government had a right to assess an income tax upon the lessor measured by the distributions to the shareholders "it must follow that they (future distributions) are available to satisfy the tax; for it would be absurd at once to hold that the dividends were the lessor's income for the purpose of assessing a tax against it, but were the shareholder's income for the purpose of collecting that very tax." As above demonstrated, this premise upon which the Court below expressly proceeded is false. In so far as it asserts that every creditor *should be paid,* we agree, but we think only out of the property of his debtor and if that is impossible the creditor must remain unpaid.

It does not follow that, because there are many situations where a taxpayer's relationship to the person or to the income may be such as to justify Congress in imposing a tax upon a particular taxpayer measured by certain in-

come which belongs to another, Congress may thereby appropriate the property of that other person to satisfy the debt owed by its taxpayer.

This Court, in *Joliet & Chicago R. Co.*, 86 L. Ed. 658, 315 U. S. 44, held that even though the rights of shareholders vested in 1864 and the lessor corporation had no right to control the payments to its stockholders and even though the lessor did not own or control the property, an income tax *measured by* such payments could be assessed against the corporation. This Court recognized the distinction between assessing an income tax and collecting it for this Court said: "Such considerations do not dispose of this controversy," which was one of assessing a tax. The Court pointed to a Treasury regulation in effect since 1914 and unchanged by Congressional action which was clearly applicable and "if valid it governs this case whatever may be the legal incidents of the 1864 Indenture under the Illinois law." Finding that the regulation was valid, the assessment of the tax was upheld. But neither that case, nor any other, holds that an income tax due from one taxpayer can be collected from the property of another even though the taxpayer's relationship to the person receiving the income or to the property may be such as would constitutionally support an assessment against him. In other words, an income tax is simply a debt and can be collected only out of the property of the debtor. As far as collectibility of tax is concerned, the ownership of property is determined by local law.

The statutes are specific in limiting the collection of taxes from the property of the taxpayer. The Collector is given authority to proceed "by distraint and sale in the manner provided in this subchapter of the goods, chattels or effects including stocks, securities, bank accounts and

evidences of debt, of the *person delinquent* as aforesaid" (26 U. S. C. A., Sec. 3690). The statute also provides for a lien "in favor of the United States upon all the property and rights to property, whether real or personal, belonging to such person (delinquent taxpayer)" (26 U. S. C. A., Sec. 3670).

Congress has granted no power to anyone to satisfy a claim for income taxes out of the property of any person except that of the taxpayer. But the Court below has.

POINT III

Stockholders of a corporation are not personally responsible for corporate income taxes.

The Court below regarded the corporate entity for the purpose of assessing a tax but disregarded it for the purpose of collecting the tax. Citing *Higgins* v. *Smith*, 308 U. S. 473, as authority, it announced the novel principle that the Treasury at its option may disregard the corporation and hold the shareholder liable for corporate income taxes. We submit that *Higgins* v. *Smith* is authority for no such proposition. It was there held only that a taxable loss was not sustained where an individual "sold" property to a corporation the stock of which was entirely owned by him. This Court in *Moline Properties, Inc.* v. *Commissioner of Internal Revenue*, 87 L. Ed. 1071, announced the rule limiting the Treasury's right to disregard the corporate form as follows:

> "In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction. *Higgins* v. *Smith*, 308

U. S. 473, 477, 478, 84 L. ed. 406, 410-412, 60 S. Ct. 355; *Gregory* v. *Helvering*, 293 U. S. 465, 79 L. ed. 596, 55 S. Ct. 266, 97 A. L. R. 1355."

Here there is no claim of fraud or even of devious conduct. The property rights in question vested in the predecessors of these stockholders seventy-five years ago through an ordinary business transaction completed in the utmost good faith and without any idea of avoiding tax.

POINT IV

In any event the Government may not collect from present stockholders income taxes due by reason of distribution to former stockholders.

The Government seeks to collect income taxes due from 1934 to 1941, both inclusive. These taxes are measured by distribution to stockholders in each of those years. Under the decision below income taxes due by former stockholders will be collected from present stockholders. Under any view of the case one person's income tax is being paid out of the property of another.

IN CONCLUSION

It is respectfully submitted that for the foregoing reasons this Court should grant the writ of certiorari as prayed for in the petition.

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